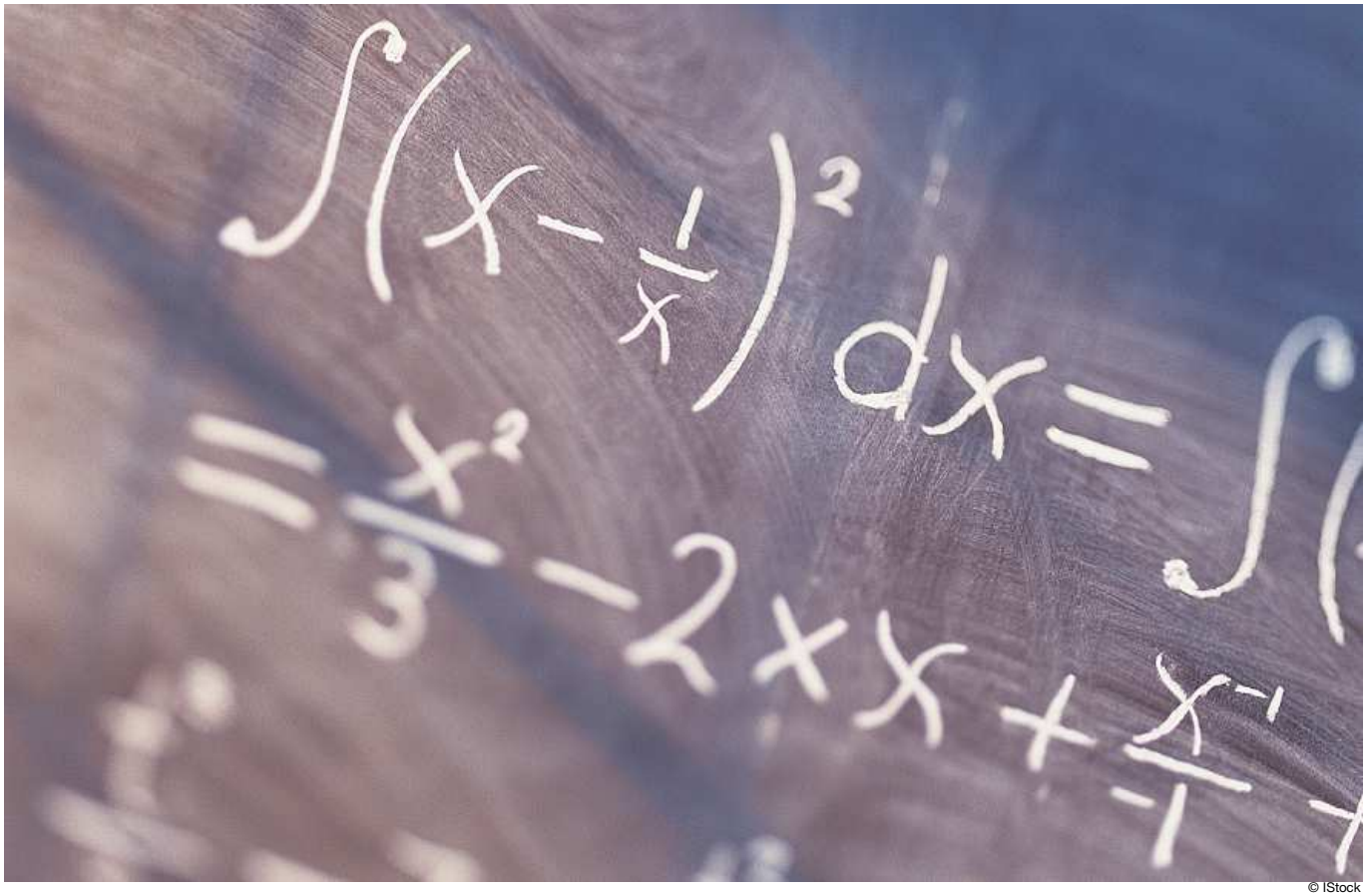
| Quarterly report |

Czech Economic Outlook

The koruna is looking for its new equilibrium



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- **We forecast overall economic growth of 2.7% in 2017,** which is our estimate for 2018 as well. Household consumption will retain its role of the most stable contributor to GDP growth.
- **Inflation is set to rise to 2.3%** on average this year, and we expect it to maintain this pace in 2018 on the back of growth of core prices due to a widening output gap.
- We expect that **the domestic inflationary pressures will imply only one hike this year** given the approximately 3% expected appreciation of the koruna versus the euro.
- **Fundamentally, the Czech economy is poised for a stronger koruna.** However, the massive speculative position is limiting room for a quick appreciation of the domestic currency and constitutes a risk of temporary but significant depreciation.
- **CZGB yields are set to gradually increase in 2017**, but this trend should be mitigated by the expected pre-election drop in supply and the year-end effect of the Resolution fund.


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The FX floor is dead. Long live interest rates!

We said that the exit from the FX floor commitment could come in the second quarter, and have now been proved to be right. The exit arrived at the very first meeting in April of the CNB Board, for which monetary questions had not originally been planned. Thus, our risk scenario in the preceding *Czech Economic Outlook* edition has materialised, and our assumption following the March meeting of the CNB Board has been vindicated. Central bankers are now letting the koruna float freely. However, they have reserved the right to intervene in case they need to. Central bankers currently do not want to influence the koruna's exchange rate, preferring rather to wait for it to find its equilibrium level.

Experience with the floating exchange rate to date indicates that currency developments have seen smooth sailing so far. However, we believe that this is the calm before the storm. **The reason is that the massive speculative position that has been building in the market during the preceding months is making the Czech currency vulnerable.** This could be seen in its weakening before the French presidential election. **Fundamentally however, the Czech economy is poised for a stronger koruna.** We believe that the exchange rate will even decline to less than EUR/CZK26 this year.

The return to a managed floating regime has not changed the key features of our macroeconomic forecast at all. We expected that the floor would be removed and we have not yet seen any exchange rate shock. The Czech economy will grow faster this year than last year. Although we did expect a surge in inflation at the end of last year and the beginning of this year, we have been surprised by its magnitude. We have therefore slightly increased our FY17 inflation estimate to 2.3%.

We expect the rate of inflation above the 2% target throughout 2017 and 2018. **If the koruna does not significantly strengthen to less than EUR/CZK26 we may see the CNB decide – for the first time in almost ten years – to hike its 2W repo rate this year.** The repo rate is now at technical zero (i.e. 0.05%). In our opinion, the CNB will take this step towards the end of this year. This should result in the growth of other interest rates in the Czech economy.

Contents

External Environment and Assumptions

The risks are political in nature

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Prospects for the US and the euro area economies remain favourable. Inflation has already increased to higher levels, while domestic demand is promising solid GDP growth. We have revised our forecast on the ECB policy outlook. In our view, the ECB will announce a reduction of its asset purchase programme in September 2017, and bring its QE programme to an end in September 2018. In December 2018 and March 2019, we expect the ECB to hike rates. The risks to our prognosis are political in nature this time. Elections in France, Germany, and possibly in Italy are ahead of us.

US: tax reform to support GDP growth

Household consumption is likely to remain the key driver of GDP growth.

US GDP growth should continue to be driven by domestic demand. Household consumption is supported by real wage growth while planned tax cuts would raise household disposable income. Business investments are expected to revive as well, mainly thanks to improvements in the energy sector. Net exports are likely to remain a drag on GDP growth. This year, the US economy is expected to add 2.2%, after 1.6% seen in 2016. Inflation in the United States probably already peaked in February at 2.7%, and in the coming months it is likely to decelerate once again. Headline inflation should average 2.1% this year, and core inflation 1.9%. Fiscal spending and implementation of tariffs represent upside risks to our prognosis. The headline PCE deflator, the preferred inflationary indicator of the Fed, is likely to reach the Fed's 2% target for the first time in the past five years.

Fed widely expected to hike rates another two times this year.

Changes in the Obamacare and the Dodd-Frank law are President Trump's main legislative priorities. Their impact on GDP growth, at least in the short term, would, however, be minimal. Conversely, the consequences of a tax reform and tax cuts for the real economy would be very significant and now represent one of the biggest uncertainties for the US economy. The final shape of the tax reform will impact US monetary policy as well. SG economists, the market and even the Fed itself expect another two rate hikes by the end of this year, and three rate hikes are expected (by SG) in 2018. The tightening of monetary conditions could be even more pronounced in the event of more significant fiscal stimulus. Fed representatives Rosengren and Williams have already stated that the Fed could even hike rates three times by the end of 2017.

Euro area: tapering to be announced in September

GDP growth in the euro area to be driven by domestic demand.

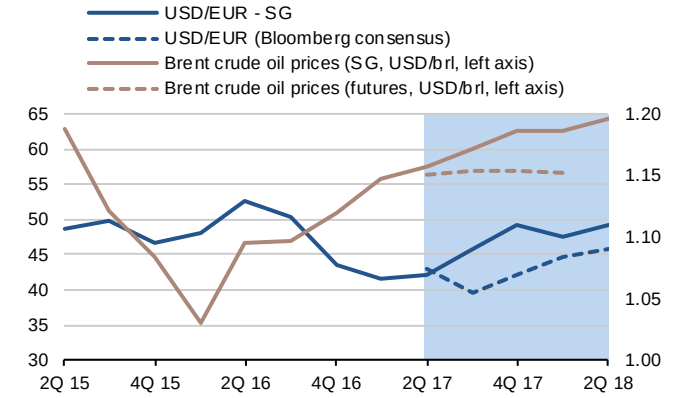
GDP growth in the euro area continues to be driven by domestic demand. Nominal wage growth is likely to be only a moderate (1.6%) this year, while inflation is much higher than last year. Consequently, real gross disposable income will grow at a slower pace. Employment growth is set to decelerate slightly as well. Still, consumer confidence is forecast to stay at solid levels, which should lead to a lower savings rate. Looking ahead, investments remain an important engine of growth. In 2016, investments contributed 0.5pp to GDP and are likely to add another 0.5pp in 2017 and 2018. Given the better-than-expected performance of the German economy in 1Q17, we have revised our GDP forecast for the euro area for this year from 1.5% to 1.8%.

QE programme to come to an end in September 2018.

Inflation in the euro area hit the ECB's 2% target. However, in March it decelerated to 1.5% again (in April it was 1.9%). We expect headline inflation to average 1.6% this year. The ECB's inflation target will probably not be achieved again in 2018-2021, when inflation should average 1.5%. Core inflation remains low. We expect it to average 1.0% this year, while over 2018-2021 it should be 1.3% on average. Low inflation is the reason why the ECB's rhetoric remains dovish.

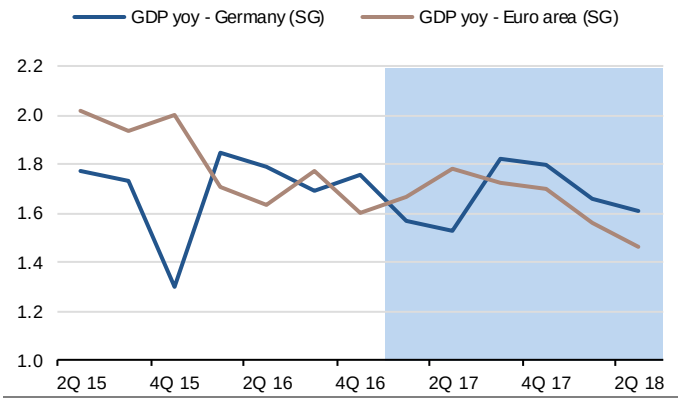
According to SG economists, the ECB is likely to announce a further reduction in its asset purchase programme in September. The programme should be reduced by €20bn as of October. In December, we expect another reduction of €10bn to be announced for January, followed by similar reductions in March, June and September, when the programme should come to an end. SG economists have substantially revised their outlook for interest rates. They estimate one hike of the deposit rate in December 2018, in light of rising euro area GDP growth above potential in 2018. Another increase in the deposit rate should follow in March 2019. After that interest rates should remain unchanged until 2021. Due to the expected ECB's policy path, we expect EUR/USD to be traded at 1.10 at the end of this year and at EUR/USD1.17 in 2018.

Oil prices and EUR/USD



Source: Macrobond, SG Cross Asset Research/Economics, Bloomberg, Economic & Strategy Research, Komerční banka

Euro area and German GDP growth (%)



Source: Macrobond, SG Cross Asset Research/Economics, Datastream, Economic & Strategy Research, Komerční banka

Germany: economy set to maintain solid growth

The labour market remains tight, and wages are growing.

Last year, the German economy added 1.9%. It should continue to perform well this year and the next, when we expect GDP growth of 1.5%. The main engine of the domestic economy is set to remain domestic demand. Labour market conditions should continue to tighten. Unemployment rate is likely to fall to 5.8% in 2018 and remain substantially below NAIRU, which we forecast at 6.6%. This should create further pressure on wage growth. The most significant wage growth should come next year, in our view, as industry wage settlements will take place at the end of this year. Consumer confidence remains high, which is reflected in households' willingness to spend. The tight labour market mentioned above and expected tax cuts (after the elections) support household consumption as well. Public consumption is likely to be boosted by expenditures connected with migration. We also expect higher investments. On the other hand, net exports are likely to be a drag on GDP growth. Accelerating inflation represents the main risk for household consumption. In February, inflation even climbed to 2.2%. However, in March it decelerated to 1.6% (in April 2%). We assume that it will not exceed 1.8% on average this year.

Elections will take place in Germany this autumn.

The main uncertainties are, this time, political in nature. In autumn (24 September), there will be election in Germany. This could mean the end of the current ruling Grand coalition. The new coalition partners (for CDU) could become Greens and FDP.

CEE region: the end of loose monetary policy

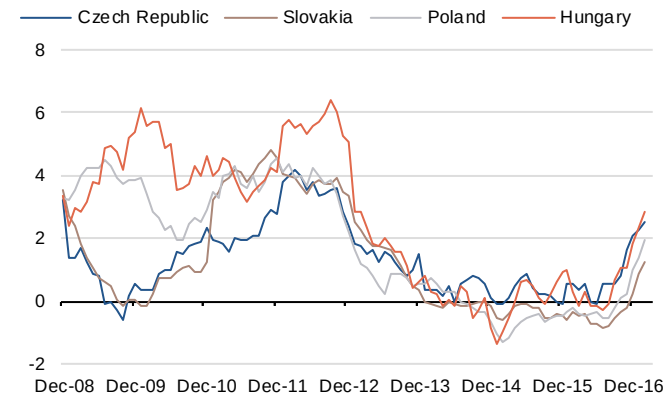
The risk of an earlier-than expected rate hike in Poland; and still very loose monetary policy in Hungary.

Inflation in the CEE region headed sharply higher in the first couple months of this year. In the Czech Republic it is already above the central bank's target. In Hungary it climbed to 3% in March, while in Poland it is hovering around 2%. The Czech National Bank reacted to

the acceleration in inflation by exiting the FX floor. In Poland, speculations about an earlier rate hike could emerge in 2H17. Inflation in Poland gathered the pace and it should stay over 2% for the rest of the year. This will likely lead the central bank to revise up its inflation outlook in July. Although our base scenario assumes rates will remain unchanged at 1.5% this year, growing inflation carries the risk of earlier rate hikes. The Hungarian central bank is maintaining extremely loose monetary policy despite rising inflation. In March, the cap on the amount of cash that commercial banks can place in the central bank was lowered to HUF 500bn for 2Q17 from 750bn HUF. The central bank is thereby trying to increase the liquidity in the market and push interest rates lower. As a result, we expect Hungarian forint to slightly weaken by the end of this year to EUR/HUF313 and polish zloty to EUR/PLN4.28 (possible transactions in the banking and energy sectors imply significant capital outflow and the risk for polish zloty).

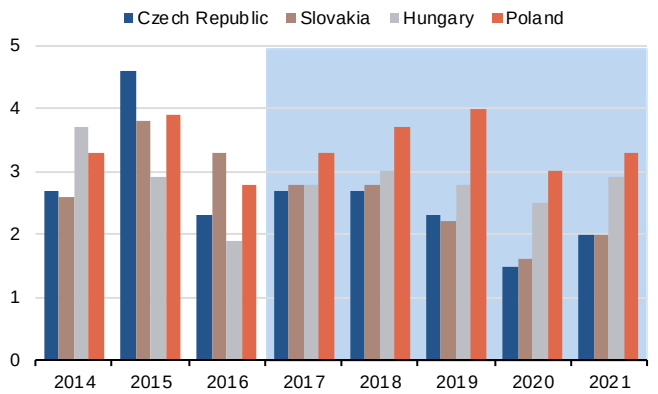
Growth in the CEE economies is likely to gather a faster pace this year. The main driver of the GDP growth should remain household consumption. Given the tight labour market, wages are set to grow again this year. However, inflation will significantly reduce household disposable income. Net exports are likely to be a drag, despite renewed world demand. On the other hand, investments are likely to gather the pace after last year's drop.

Inflation in the region is accelerating



Source: Macrobond, Eurostat, Economic & Strategy Research, Komerční banka

GDP growth will gather the pace



Source: Macrobond, Eurostat, SG Cross Asset Research/Economics, Economic & Strategy Research, Komerční banka

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Macroeconomic Outlook

Growth to accelerate despite FX volatility

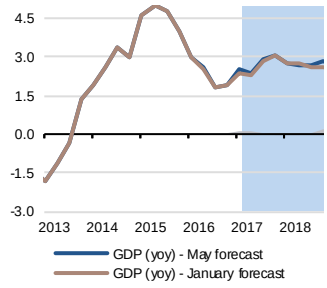
High frequency data suggest that the global economy has accelerated in the beginning of this year. The Czech economy has been benefiting from these developments as well. Despite growth in commodity prices, the trade balance remains in strong surplus, though slightly lower than last year. Positive developments should persist through the rest of the year. Household consumption should continue to be the main growth driver, while fixed capital formation will likely post muted growth. We expect growing external demand to support domestic exporters, but rising input prices to impede growth in the trade surplus in nominal terms. As a result, we expect economic growth to accelerate and the output gap to widen further. We see strengthening GDP growth being reflected in the labour market with another drop in the unemployment rate, leading to higher wages. The widening output gap should drive core inflation higher, which would mean headline inflation is likely to overshoot the CNB's target throughout 2017 and 2018.

Main changes

GDP:
We keep our full-year GDP outlook for 2017 and 2018 unchanged. We believe economic growth will accelerate this year to 2.7% and retain this pace in 2018.

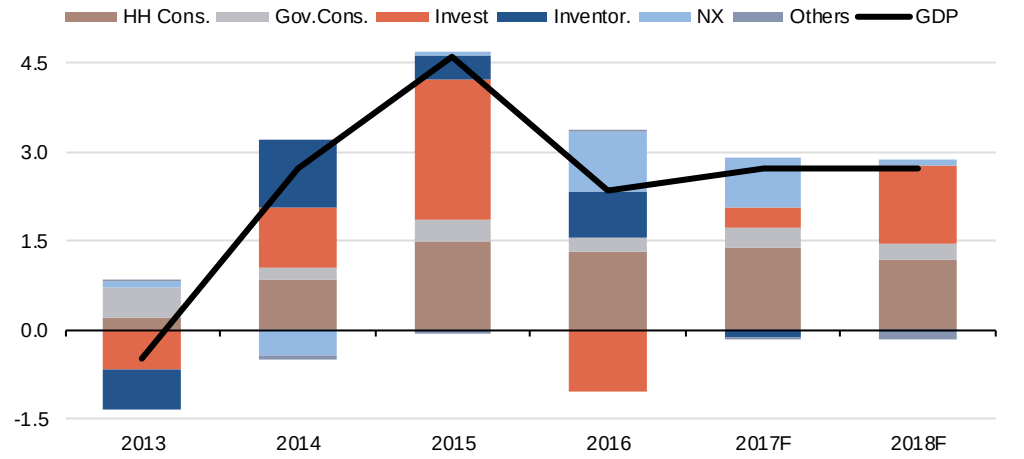
Inflation:
Inflation has surpassed our previous forecast, due largely to a surge in food prices. We thus revise our estimate for this year one tick higher to 2.3%. We keep our 2018 projection of 2.3% unchanged.

Change in our GDP outlook (%)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

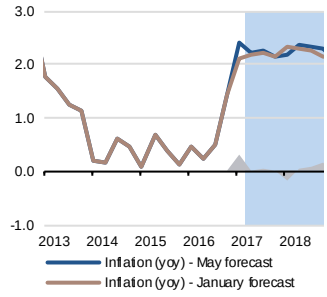
Growth to be supported by domestic demand, investment to join the party in 2018



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Despite political risks, global economic growth accelerated in 1Q17, at least according to forward-looking indicators and monthly data. Positive developments have also been apparent in the Czech economy. Germany's economic performance has been supported by a recovery in China and the US. Many Czech businesses serve as a subcontractor for part of Germany's exports. Moreover, domestic demand in Germany and the rest of the euro area remains sound. Thus, in the first months of the year, Czech external trade almost repeated the record results from last year, despite rising import prices.

Change in our inflation outlook (%)



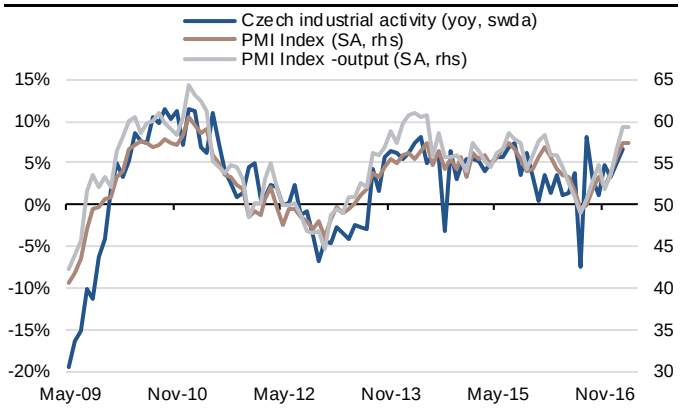
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Forward-looking indicators suggest that the Czech economy accelerated rapidly in 1Q17, and the monthly data corroborate this view. Industrial production briskly accelerated in the beginning of the year on the back of external demand. Domestic demand fuelled an advance in services. The only sector that seems reluctant to grow is construction, which is still suffering from a lack of public infrastructure projects. In contrast to our expectations, the unemployment rate has decreased further, but wage growth is not accelerating. That said, the wage growth has been strong enough to boost disposable income and thus support the most important growth contributor, private consumption. Investment

remains weak, but government consumption increased as the election year began. **All in all, we forecast 1Q Czech GDP growth at a sound 1% qoq. For the rest of the year, we think the economy will lose some momentum, but the positive trend should persist. We thus forecast overall economic growth of 2.7% in 2017, which is our estimate for 2018 as well,** supported by a revival in investment activity.

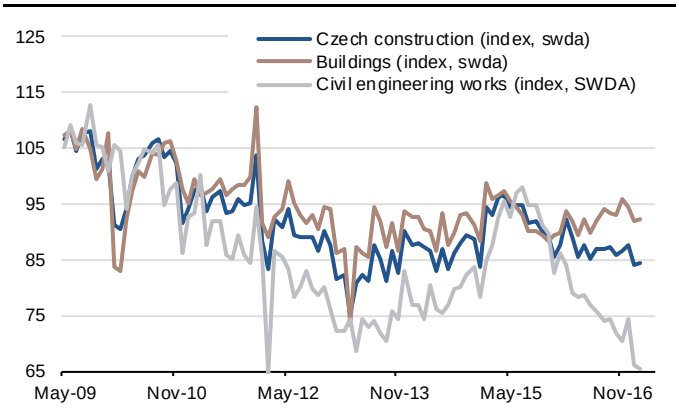
Industrial production surged at the beginning of the year. The strong readings were supported by automotive production, as demand for cars in the euro area, Germany in particular, have remained strong. **The Czech automotive industry is continually increasing its value-added and expanding its production capacities.** The sector should thus remain the main driver of industrial output. Other sectors are doing well. Chemicals reported double-digit yoy growth thanks to base effects, as it suffered from one-off shutdowns last year. Electricity production tells a similar story, as nuclear power plants had problems last year. External demand should remain on an upward trajectory and investment in the domestic economy should recover, supporting to Czech industry. We expect industrial output to increase 7.3% in 2017, helped by favourable calendar effects. After adjustment, we see this growth at 6.7%.

PMI suggests strong industrial production



Source: Reuters, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Civil engineering works at a low point (2010=100)



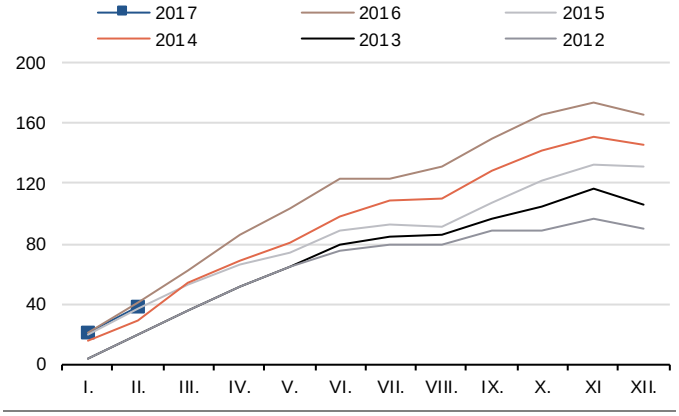
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Construction sector did not start 2017 on a high note. Although there is demand for new projects in both infrastructure and residential housing, the circumstances are still not favourable for construction firms. **The public sector still does not have projects ready for realisation.** Just a small part of planned construction has begun, but we expect more projects to come through in 2H17. Residential housing developers are still facing the lack of modern zoning plan in Prague and delays with the issuance of building permits. Thus, they cannot flexibly react to surging demand for housing, especially in the capital.

Exporters are hedged, so EUR/CZK appreciation will have a limited impact on them this year.

After 41 months with the FX commitment, exporters have to face FX volatility once again. Although we have yet to see rapid koruna appreciation, we expect the EUR/CZK rate to move down in the coming months (more about currency in the *Czech FX Market* section). **We assume most of the exporters have hedged their euro exposure for 2017 and that many of them have hedged at least part of their exposure up to five years forward. Expected appreciation should thus have virtually no impact on exporters this year**, and only a limited impact next year. Moreover, our forecasts assume that appreciation will be gradual in 2018 and beyond.

This year's external trade performance close to last year's record results (CZKbn, national methodology)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Rising commodity prices will drag the commodity balance deeper into the red.

Rising export prices and modest growth in external demand should propel Czech exports in nominal terms. As with industry, automakers are likely to remain the growth driver for exports, but other sectors should also benefit from the expected revival of investment activity in the euro area, Germany in particular (see the *External Environment and Assumptions* section). **On the other hand, rising commodity prices on global markets are pressuring the commodity balance. We expect the deficit here to deepen rapidly this year. That said, external trade in nominal terms should post a similar surplus as last year.** In real terms, however, we expect the surplus to increase and external trade to contribute 0.8pp to the GDP growth.

Fiscal policy: Fiscal expansion on the go

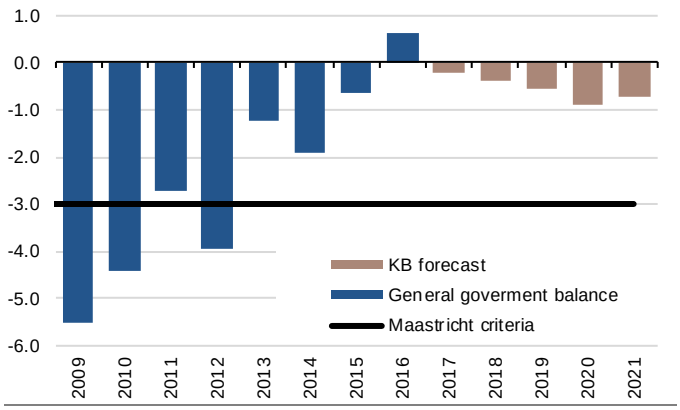
Last year, the Czech public sector reached a surprisingly large surplus of 0.6% GDP.

Last year, the Czech public sector reached a surprisingly large surplus of 0.6% GDP using the ESA2010 methodology. For the first time in its history, the general government posted a positive balance. The result was driven mainly by massive local government surpluses, which stood at 1% of GDP. On the one hand, their revenues were boosted by the growing economy, and thus higher tax intakes. Meanwhile, on the expenditure side however, there was a sizeable drop in investment due to the cycle in EU funds. That said, central government, posted yet another deficit of 0.4% of GDP last year. The massive central budget surplus of 2016 in the cash methodology was driven mostly by late EU funds inflows, which related to projects realised in previous years. Thus, under the ESA2010 rules, those budget revenues were adjusted for and the central government balance plummeted into the red.

We expect general government to post a deficit of 0.2% of GDP this year.

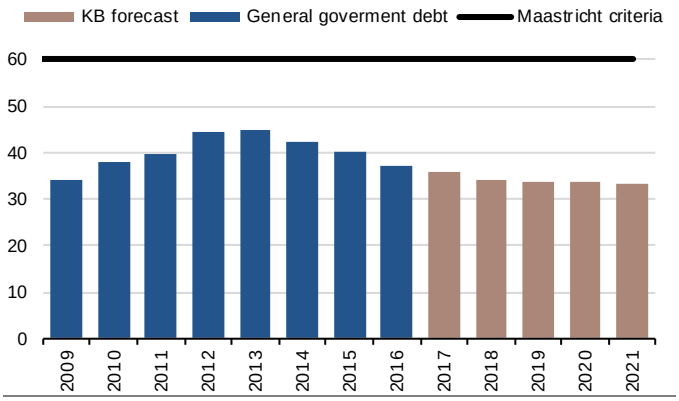
We expect general government to post a deficit of 0.2% of GDP this year. While we look for further surpluses by local governments (strong revenues versus lack of spending opportunities and/or an inability to spend), the central government's expected shortfall should draw the overall balance into the red.

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Using the cash methodology, the central government budget is set to print a CZK45bn deficit, in our view.

Using the cash methodology, the central government budget is set to print a CZK45bn deficit, in our view. This compares with the CZK60bn official plan, as we continue to look for a faster growth of GDP (4.5% in nominal terms) and its components vis-a-vis the Finance Ministry forecast the budget was built on (3.5%). As we stated in previous editions of the *Czech Economic Outlook*, the 2017 fiscal policy is expansionary. The government has increased public-sector wages, contributions into the healthcare system and social benefits including an extraordinary rise of pension benefits. On the revenue side, tax rates have remained unchanged (except for a higher tobacco taxes, most notably), but the Finance Ministry started the online sales-registering system in order to support tax collections. The government has pushed for an increase in infrastructure investment and repairs. It seems that several infrastructural projects are finally starting, most notably the construction of new highways and repair work on existing roads. **We estimate this year's fiscal effort at -0.9% (a stimulus) mostly due to higher government consumption**.

Public finance dynamics

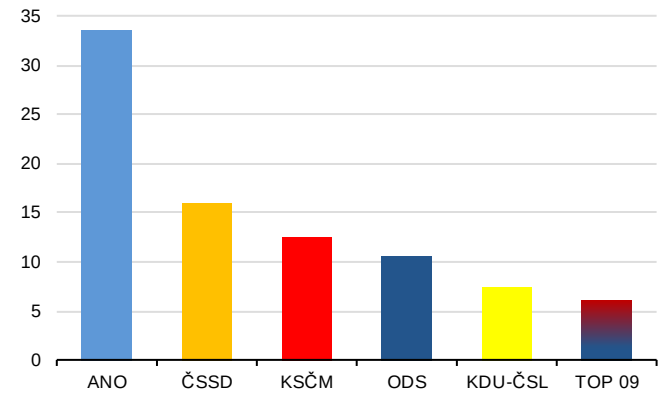
	2016	2017f	2018f	2019f	2020f	2021f
Balance (% GDP)	0.6	-0.2	-0.4	-0.6	-0.9	-0.7
Fiscal effort (pp GDP growth)	0.7	-0.9	-0.2	-	-	-
Public debt (CZKbn)	1,755	1,760	1,780	1,810	1,860	1,900
Debt ratio (% GDP)	37.2	35.7	34.3	33.5	33.8	33.4

Source: CZSO, Finance Ministry, Economic & Strategy Research, Komerční banka

General elections in October to bring few changes to economic policy

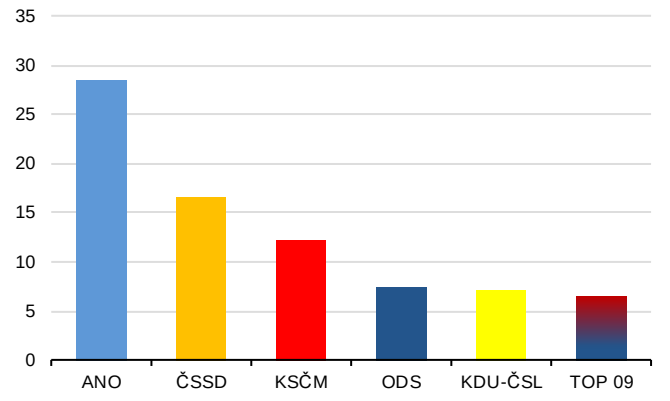
The general election for the lower chamber of the Parliament will be held on 20-21 October. **The junior party of the current coalition government, ANO, is leading at the polls by a considerable margin**. ANO is a centrist party led by the current finance minister Andrej Babiš and its programme contains an anti-corruption ethos, market-friendly economic policy (no increases in tax rates but a push for improvement of tax collection), and a pragmatic stance toward the EU (albeit with a refusal to enter the euro area). It is unlikely that ANO will be able to form a one-party government, however. Depending on the result of the elections, ANO can join forces with either the leftist parties (Social Democrats – ČSSD, Communists – KSČM), centre-right parties (ODS, TOP09) or centrists (Christian Democrats and Mayors – KDU-ČSL/STAN). While ANO has not published its political programme for the 2017 election yet, we assume government policies would see very few changes.

Voting model, 24 April 2017 – CVVM



Source: CVVM, Economic & Strategy Research, Komerční banka

Voting model, 26 April 2017 – STEM



Source: STEM, Economic & Strategy Research, Komerční banka

The debt-to-GDP ratio should decline to 35.7% in 2017 due to continuing economic growth.

Public debt: Favourable trajectory of debt-to-GDP ratio

In 2016, public debt dropped massively year-on-year from 40.3% of GDP to just 37.2% (CZK1,755bn) mainly due to the decline in central government debt (the cash budget surplus of CZK62bn was mirrored by lower central government debt of CZK60bn). This year, we forecast a very modest increase in the volume of debt by CZK5bn. The adverse effect of the expected central budget deficit is to be mitigated by a liquidity reserve tap (to the tune of CZK15bn; as of end-2016, the reserve amounted to CZK162.2bn) and by further local government surpluses, in our view. The debt-to-GDP ratio should decline to 35.7% in 2017 due to continuing economic growth.

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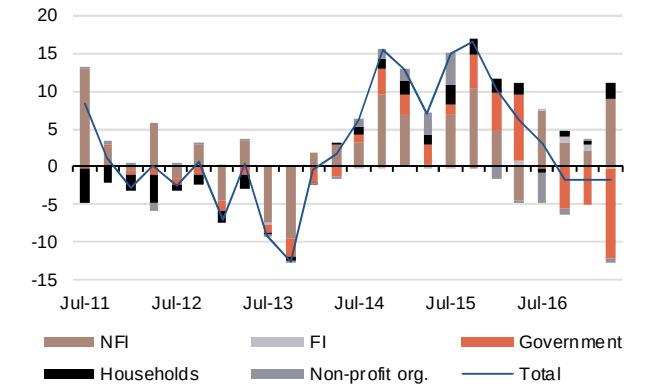
Infrastructure investment to start gradually

Key infrastructural projects have been delayed.

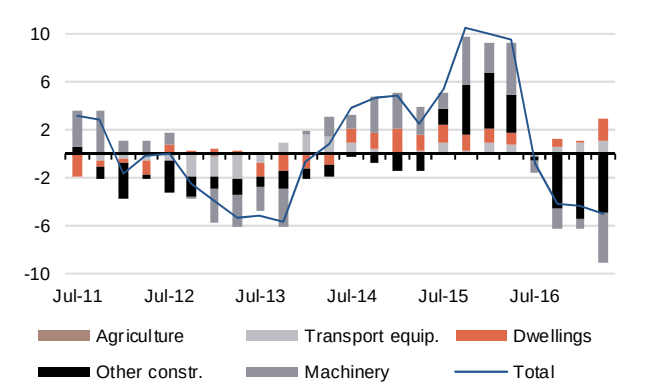
As we described above, although the government has devoted a relatively large sum of money to infrastructure, we fear that it will not be able to tap all these funds. Investment activity will thus remain subdued. Several key infrastructure projects have been delayed to 2H17, and we see significant risk of further postponements.

Government investment dropped sharply (% yoy) …



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

… especially in the construction sector (% yoy)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

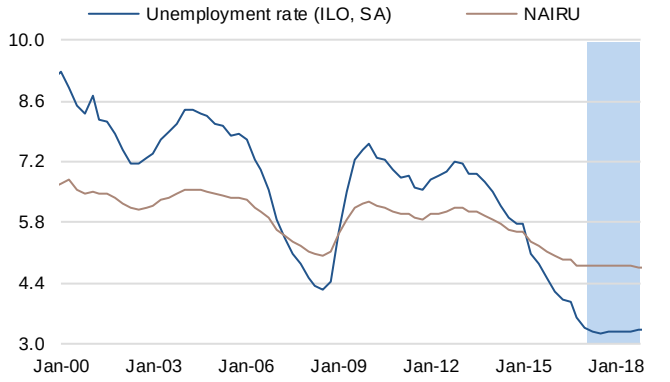
The conditions for private investment are still rather favourable. The Czech economy has entered the fourth consecutive year with above-potential growth, and though the business cycle has already passed the recovery phase and is deeply in expansion mode, interest rates are still very low. **The economy's medium-term growth prospects remain decent, and the economic trends among the country's main business partners have been surprising to the upside.** On the other hand, rising wages will press on profit margins, leaving less money for investment.

Consumption to remain stable growth driver

Household conditions remain exceptional: unemployment has hit new lows, and wage growth is accelerating.

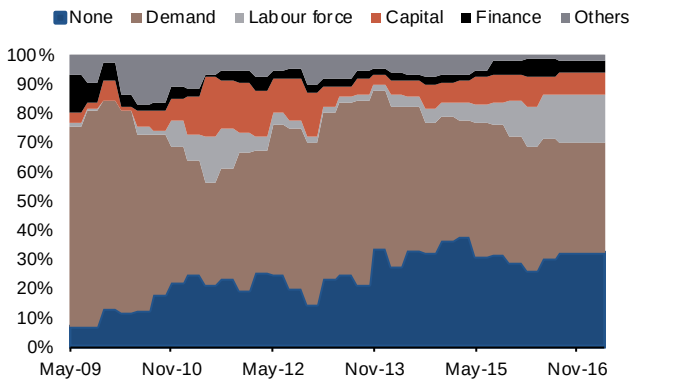
The unemployment rate has surprised by declining further. **The Czech Republic reported the lowest unemployment rate in the EU, and the rate also hit a historical low for the country.** Once again, we do not think the unemployment rate has much room to decline. In January, the unemployment rate (ILO methodology) dropped to 3.3%, and we expect this to be its bottom. The pool of available workers is already very small. Finding a suitable workforce is therefore very difficult. This problem is especially acute for particular regions and for particular sectors. Industry has been hit especially hard by the shortage of labour.

Unemployment rate deeply below NAIRU (%)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Barriers for industry: lack of labour force is growing concern



Source: European Commission, Macrobond, Economic & Strategy Research, Komerční banka

The lack of labour force should lead to wage growth acceleration. Despite the shortage of workers, wage growth has been reluctant to gain pace. Moreover, the remuneration growth is being driven by the public sector, while private firms do not offer pay rises that often. We assume that wage negotiations for this year did not account for a surge in inflation, as the surge in prices came very late last year. **We expect nominal wage growth to repeat last year's 4.2%.** Thus, real wage growth look set to decelerate this year to 1.9% due to higher inflation, vs 3.6% in 2016. We believe wage growth will accelerates in 2018, as negotiations should take into account the return of inflation. Our 2018 forecast is for 4.7% growth in nominal terms and 2.3% in real terms.

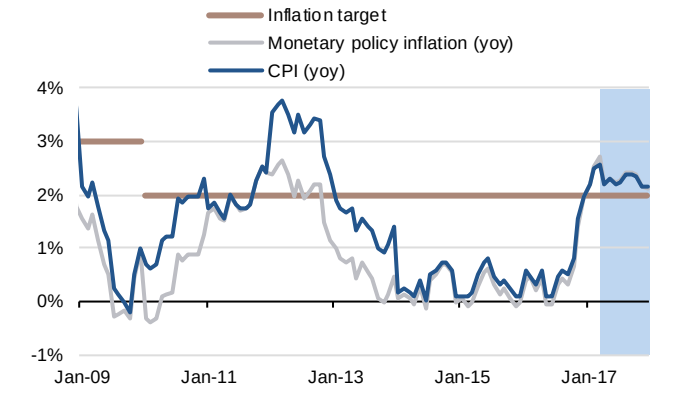
The increase in disposable income due to higher employment and solid wage growth has been fuelling private consumption. Household spending has been the most stable contributor to GDP growth in the past two years, and it is set to retain this role. Although real disposable income is decelerating, private consumption should remain stable. Households are benefiting from the stable economic outlook, and given the very low unemployment rate, they can be less cautious with their spending. **Thus, consumer spending growth should remain at 2.9% this year.** Next year, there are several factors that will weigh on consumption. Higher prices will fully enter spending considerations. Rental prices in particular have been increasing and might be a

drag on other types of consumption. That said, real disposable income growth will likely accelerate. All told, we thus forecast a slowdown in consumption growth to 2.5% in 2018.

Inflation to overshoot CNB's target in 2017 and 2018

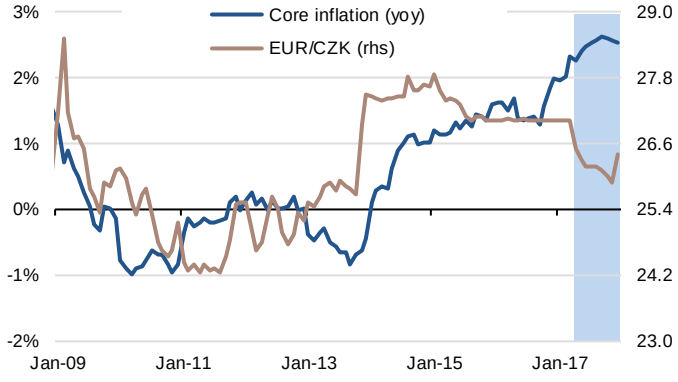
In 1Q17, the food prices surprised us with rapid growth and administered prices with a rather shallow decline. While the surge in food prices is set to fade, as it was caused by one-off event, the dynamics in regulated prices is a sign of cost pressures in the economy. Core inflation has accelerated in line with our forecast and it set to grow further this year. The headline figure should rise to 2.3% on average this year, and we expect it to maintain this pace in 2018 on the back of growth of core prices due to a widening output gap.

Inflation to keep overshooting the 2% target…



Source: CZSO, CNB, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka

… mainly thanks to core prices



Source: CZSO, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka

Core inflation, according to our calculations, printed at 2.3% in March and thus confirmed its steep upward trajectory. The pick-up is especially apparent in the non-tradables, which suggest that domestic inflationary pressures are robust. We believe that higher prices of food and fuels have already started passing through into the core element. Moreover, the widening output gap is set to pressure wage growth which will serve as another cost pressure for prices. The expected strengthening of EUR/CZK is a disinflationary factor. However, part of the appreciation will end in the margins of retailers as growing sales will not spur them to decrease prices much. **We expect core inflation to accelerate further and consistently print at 2.6% yoy in 2H17. On average, we forecast core price growth of 2.4% this year.** Core inflation should maintain this trend in 2018.

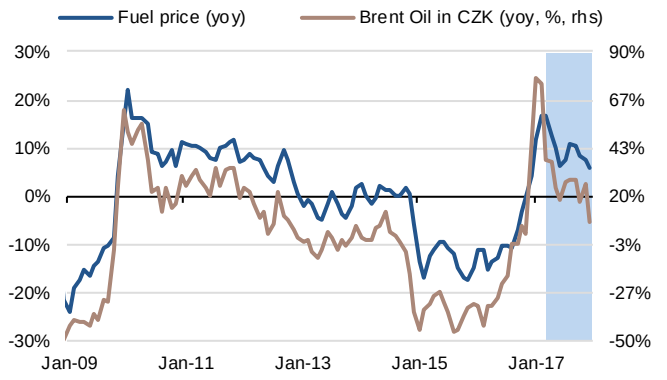
Food price inflation to remain elevated this year.

Food prices surged in the beginning of the year, due mainly to unfavourable weather in Southern Europe, which dented fruit and vegetable production. This effect is currently fading, but other items in the food basket are joining the rally. Prices across the food items in the consumer basket are catching up with what they lost at the turn of 2015 and 2016. We expect some moderation of food price growth as fruit and vegetable prices normalise in 2Q17, but in yoy terms, we think food inflation will remain in positive territory. **Overall, food price growth should come in at 3.2% growth this year,** after printing two consecutive declines in 2015 and 2016. **Next year, we see food prices growing 2.2%.**

Fuel price inflation peaked in 1Q17.

Fuel price inflation spiked in 1Q17 due to strong base effects. Fuel prices will likely grow modestly this year, as we expect continual oil price growth. On the other hand, their advance will be impeded by appreciation koruna against dollar. While fuel prices should remain on an upward path in yoy terms, the strength of this trend will likely fade and the contribution to headline inflation diminish. Fuel price inflation will continually pass through into other items of the CPI basket. **Overall, we expect fuel prices to increase 9.6% this year.**

Fuel price inflation already peaked



Source: Bloomberg, CZSO, Macrobond SG Cross Asset Research/Economics, Economic & Strategy Research, Komerční banka

Administered prices to grow as late as next year.

Administered prices slightly increased in the beginning of the year, while we had expected a drop. Gas prices for households reacted with a rather large lag to the decline in global gas prices, but the modest drop here was offset by a rise in the price of electricity and other regulated items. **We expect regulated prices to post marginal growth in the remainder of the year and the average for 2017 to be in line with 2016. In the beginning of 2018, energy prices should increase and we expect administered prices to grow 1.8%.**

Risks: sudden depreciation would create high inflation

Sudden depreciation would push inflation higher.

Although the EUR/CZK has not been showing much volatility so far, we see a significant risk of sudden moves if global financial markets become stressed (see more in the section *Czech FX Market)*. Depreciation of CZK would increase import prices, which would be followed by a surge in inflation, possibly above the central bank's tolerance band. This risk relates mainly to the elections in Europe (France, Germany and the UK) that will be held this year. On the other hand, sharp appreciation of EUR/CZK triggered by market speculation would curb inflation and jeopardise export competitiveness.

Investment to remain a weak point in the long-term growth scenario.

Our baseline scenario assumes that construction of key infrastructure projects will begin in 2H17. Although, these projects have already been delayed several times, there is still the risk of further postponements. This would weigh down GDP growth this year and even more so in 2018.

Key economic indicators

	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	2016	2017	2018	2019	2020	2021
GDP and its breakdown														
GDP (real, yoy)	2.4	2.7	2.4	2.9	2.7	2.7	2.8	2.7	**2.3**	**2.7**	**2.7**	**2.3**	**1.5**	**1.9**
Household consumption (real, yoy)	2.9	2.7	3.2	2.9	2.8	3.0	2.9	3.1	**2.9**	**2.9**	**2.5**	**1.5**	**0.7**	**1.0**
Government consumption (real, yoy)	1.0	1.6	0.8	1.2	1.9	1.3	1.1	1.1	**1.2**	**1.9**	**1.4**	**1.4**	**1.8**	**1.7**
Fixed investments (real, yoy)	-1.8	1.1	4.7	2.8	2.6	2.5	3.3	3.4	**-3.8**	**1.4**	**5.3**	**4.4**	**3.9**	**3.7**
Net exports (contribution to yoy)	0.3	0.6	0.1	0.4	0.3	0.7	0.5	0.7	**1.0**	**0.8**	**0.1**	**0.4**	**0.3**	**0.4**
Inventories (contribution to yoy)	1.1	0.2	-0.4	0.0	0.1	-0.2	-0.2	-0.3	**0.8**	**-0.1**	**0.0**	**-0.3**	**-0.8**	**-0.3**
Monthly data from the real economy														
Foreign trade (CZK bn) (*) (***)	117.3	117.4	121.6	123.5	125.9	130.1	129.1	130.2	**486.9**	**485.6**	**473.8**	**478.2**	**485.8**	**506.9**
Exports (nominal, yoy) (*)	-1.0	1.1	5.4	7.1	6.6	6.2	5.8	6.1	**2.4**	**6.8**	**6.9**	**3.1**	**2.4**	**4.6**
Imports (nominal, yoy) (*)	-0.8	3.6	6.9	6.5	6.4	5.8	5.8	6.2	**0.4**	**7.7**	**8.0**	**3.4**	**2.5**	**4.6**
Industrial production (real, yoy)	4.0	3.2	3.8	6.4	4.1	3.8	4.5	4.8	**2.9**	**7.3**	**5.1**	**2.9**	**2.1**	**3.7**
Construction output (real, yoy)	-4.1	-1.6	3.7	2.4	2.3	0.6	2.0	3.5	**-6.1**	**-0.2**	**5.5**	**3.4**	**2.1**	**2.2**
Retail sales (real, yoy)	5.6	4.8	4.9	5.1	4.0	4.3	4.3	4.2	**5.6**	**3.9**	**4.3**	**2.0**	**-0.6**	**-0.2**
Labour market														
Wages (nominal, yoy)	3.9	4.4	4.6	4.6	4.8	4.8	4.6	4.3	**4.2**	**4.2**	**4.7**	**2.7**	**0.7**	**1.8**
Wages (real, yoy)	2.4	2.2	2.3	2.3	2.6	2.3	2.2	2.0	**3.6**	**1.9**	**2.3**	**0.9**	**0.0**	**0.5**
Unemployment rate (MLSA)	5.2	5.2	4.6	4.7	5.0	5.1	4.5	4.5	**5.4**	**4.1**	**3.5**	**3.5**	**3.9**	**4.2**
Unemployment rate (ILO 15+)	3.8	4.0	3.7	3.8	3.7	3.9	3.6	3.7	**4.0**	**3.3**	**3.3**	**3.4**	**3.8**	**4.0**
Employment (ILO 15+, yoy)	2.0	1.4	1.1	0.7	0.3	0.1	0.0	-0.1	**1.9**	**1.5**	**0.3**	**0.0**	**-0.5**	**-0.3**
Consumer and producer prices														
CPI Inflation (yoy)	1.4	2.1	2.2	2.2	2.1	2.3	2.3	2.2	**0.7**	**2.3**	**2.3**	**1.7**	**0.7**	**1.2**
Taxes (contribution to yoy inflation)	0.1	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	**0.1**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Core inflation (yoy) (**)	1.8	2.1	2.4	2.6	2.6	2.6	2.4	2.2	**1.6**	**2.4**	**2.4**	**1.8**	**0.5**	**1.2**
Food prices (yoy) (**)	1.2	2.8	3.0	2.2	1.7	1.3	1.4	1.3	**-0.9**	**3.2**	**2.2**	**2.4**	**2.0**	**2.1**
Fuel prices (yoy) (**)	0.2	13.5	9.4	7.8	5.7	1.7	1.2	1.1	**-8.5**	**9.6**	**2.8**	**-0.5**	**-1.0**	**-1.7**
Regulated prices (yoy) (**)	-0.1	-1.1	-0.7	-0.3	-0.2	2.4	3.1	3.8	**0.2**	**0.0**	**1.8**	**1.2**	**0.4**	**1.0**
Producer prices (yoy)	-1.1	2.9	3.3	4.1	4.0	3.2	2.8	2.4	**-3.2**	**3.1**	**2.5**	**1.5**	**1.0**	**1.6**
Financial variables														
2W Repo (average)	0.05	0.05	0.05	0.05	0.05	0.05	0.24	0.65	**0.05**	**0.09**	**0.79**	**0.87**	**0.84**	**1.92**
3M PRIBOR (average)	0.29	0.29	0.29	0.29	0.29	0.29	0.41	0.88	**0.29**	**0.31**	**0.99**	**1.04**	**0.99**	**2.05**
EUR/CZK (average)	27.02	27.02	26.40	26.50	26.50	25.84	25.31	24.91	**27.0**	**26.4**	**25.8**	**24.8**	**23.8**	**23.0**
USD/CZK (average)	25.09	27.02	25.14	24.77	24.31	23.93	23.43	22.86	**24.4**	**24.4**	**23.2**	**21.1**	**19.8**	**18.9**
External environment														
GDP in EMU (real, yoy)	1.8	1.7	1.8	1.7	1.5	1.4	1.4	1.4	**1.7**	**1.7**	**1.5**	**1.2**	**0.6**	**1.2**
GDP in Germany (real, yoy)	1.9	1.6	1.6	1.8	1.5	1.5	1.4	1.3	**1.8**	**1.7**	**1.6**	**1.2**	**0.7**	**1.5**
CPI in EMU (real, yoy)	0.7	1.5	1.5	1.5	1.5	1.4	1.5	1.5	**0.2**	**1.6**	**1.5**	**1.5**	**1.5**	**1.4**
Brent oil price (USD/brl, average)	51.0	52.5	55.0	57.5	60.0	62.0	64.0	66.0	**45.0**	**58.9**	**65.0**	**70.0**	**75.0**	**75.0**
EURIBOR 1Y (average)	-0.07	-0.07	-0.08	-0.08	-0.08	-0.09	-0.08	-0.08	**-0.03**	**-0.07**	**0.15**	**0.20**	**0.19**	**0.36**
EUR/USD (average)	1.08	1.00	1.05	1.07	1.09	1.08	1.08	1.09	**1.11**	**1.08**	**1.11**	**1.18**	**1.21**	**1.21**

Source: CZSO, MLSA, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka
Note: (*) foreign trade according to cross border statistics;
(**) these parts of inflation are adjusted for the primary effect of indirect tax changes;
(***) the quarterly data are seasonally adjusted.

CNB Focus

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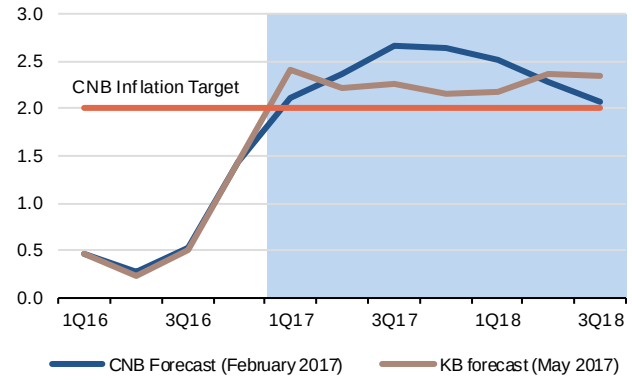
The CNB to push through the desired appreciation using hikes

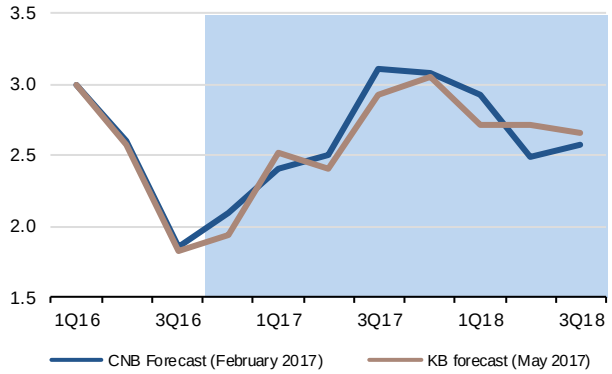
In line with our expectations, the CNB has already abandoned the policy of FX commitment in the second quarter of this year. Yet, monetary conditions have not tightened much, with the currency not appreciating as the market or the CNB had expected. Our forecasts indicate that the economy needs tighter monetary policy, which will be delivered either by currency appreciation due to speculative flows or pushed through by hikes from the CNB. The central bank will have to be very cautious with the timing of its first hikes as the uncertainty about the development on the *Czech FX Market* remains elevated and too much appreciation would cause too much tightening. Given the risks on the *Czech FX Market*, we expect the CNB will wait before applying its first hike until it is more confident about the exchange rate dynamics.

Inflation to remain at the target…



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

…pushed by above-potential GDP growth



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

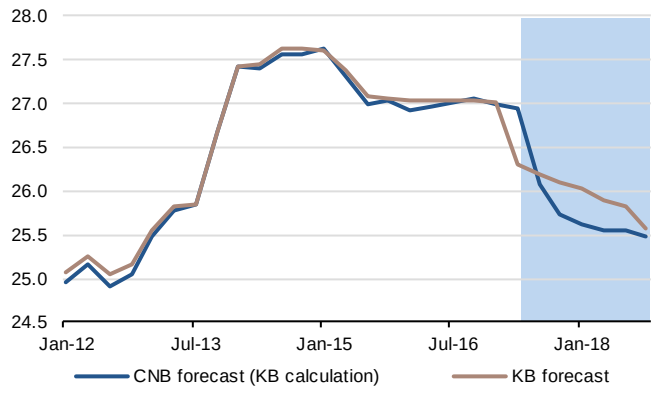
Appreciation vs. hikes equivalency

At the moment, we believe that the tightening of monetary policy conditions works only through the FX channel. Investment growth is very dependent on the EU funds cycle (see a thorough analysis of the EU funds effect at http://bit.ly/ECOU4Q16EN) while interest rates are less important in the investment decision. Consumer loans' weighting in GDP is very small (4.7%) and we would be hard pressed to find evidence that consumer loan dynamics would depend heavily on interest rates. Therefore, we believe that if the central bank increases interest rates, most of the tightening of monetary conditions would come through exchange rate appreciation. We assume that an expected hike of 0.25pp would push the EUR/CZK down by 1%. Given the size of the speculative position, we believe that unexpected hikes would have a much stronger impact as they would probably shift interest rate path expectations. We assume that the CNB's macroeconomic model would correctly forecast a 1% appreciation approximately equivalent to a 0.25pp hike, although the channels are different.

Premature hiking might induce exaggerated tightening

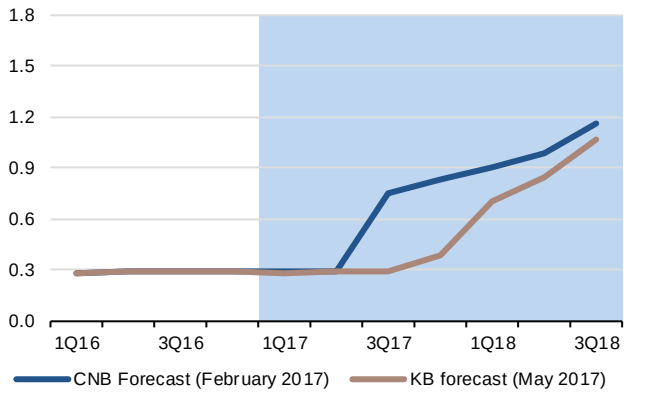
The uncertainty about FX rate developments will delay the first hike. Governor Rusnok has repeatedly stressed that the central bank will let the EUR/CZK find its new post-commitment equilibrium without central bank's influence. This might, according to Rusnok, take "*weeks, maybe even months*"[1]. Only after the CNB is sure that the market will not provide the necessary monetary policy tightening through currency appreciation itself, the CNB will start hiking the rates, in our view. Otherwise, the CNB would risk a too-steep appreciation, which might push the CNB to backtrack which is probably the last thing the CNB would like to risk. It would not only be a shock to inflation but also for exporters. We believe, therefore, that the CNB will wait on the first hikes until the last quarter of the year even though its forecasts may continue suggesting a steep hiking path beginning immediately. The CNB itself plays down its own forecast. A steep hiking path beginning in the third quarter of the year is, according to CNB officials, only confirmation that the exit was conducted at the right time and such guidance should be taken with a pinch of salt.

CZK appreciation to tighten monetary conditions…



Source: CNB, Bloomberg, Economic & Strategy Research, Komerční banka

…so the hike is set to come as late as the last quarter of the year (3M PRIBOR)



Source: CNB, Bloomberg, Economic & Strategy Research, Komerční banka

Our own outlook does not suggest such strong inflationary pressures from the domestic economy as the CNB's and so we do not assume rate hikes are necessary in the short term. This should become apparent as early as the start of the summer. Our outlook is based on a currency appreciation towards EUR/CZK26, a slightly weaker exchange rate than the CNB assumes. All in all, we expect that the domestic inflationary pressures will imply only one hike this year given the approximately 3% appreciation of EUR/CZK, while the CNB expects 4% appreciation and as many as three hikes.

Even when we see less domestic pressure, we assume that if the exchange rate remains in the recent range of 26.50-27.00 and showing very little volatility, the bank board might take it as a sign that the new equilibrium has been reached earlier than expected and that some immediate tightening of monetary policy is necessary. In such an event, we could rule out a first hike as early as the summertime. Next year, we expect a steady hiking path of 25pp per quarter as the positive output gap will be creating inflationary pressures on an ongoing basis.

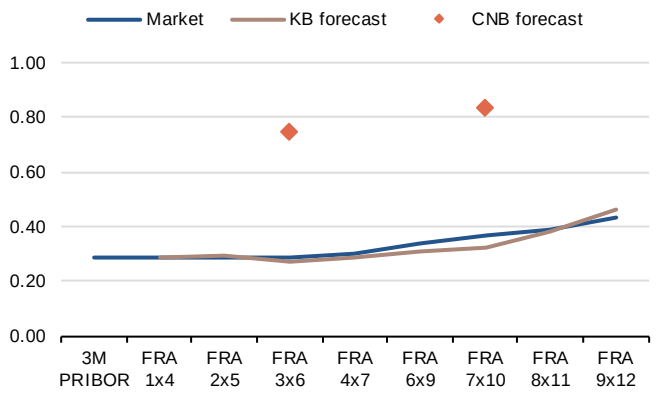
[1] https://www.cnb.cz/cs/verejnost/pro_media/clanky_rozhovory/media_2017/cl_17_170411_rusnok_idnes.html

Outright intervention only as a last resort

The CNB does not want to interfere with the exchange rate directly. The bank does not even want to give markets any indication where it sees the exchange rate in its forecast (although the assumptions about the EUR/CZK can be derived from data provided by the CNB). The central bank is afraid that any stated level might be perceived by investors as a new floor and might be tested by the market. This does not mean that the CNB would not react to excessive moves. We believe that the CNB will step into the market with outright interventions when the koruna appreciates below EUR/CZK25 or depreciates above 28 as both possibilities would jeopardize fulfilling the CNB's inflationary target.

The CNB board will present a new forecast at the upcoming meeting on 4 May. We believe that this forecast will still point to above-target inflation on the monetary policy horizon. However, the overshooting should be modest only in 2018. The Governor will, in our view, repeat that the CNB will not interfere with the Czech *FX Market* and that it wants to wait for the EUR/CZK to find its new equilibrium. Rusnok will likely play down the bank's rapid hiking forecast simply as confirmation that the end of the commitment was done at the right time. In contrast, he will stress that the CNB is ready to start the hiking cycle once it is more certain about FX developments. The markets are still reluctant to price in the hikes.

Markets reluctant to price a full hike this year



Source: CNB, Bloomberg, Economic & Strategy Research, Komerční banka

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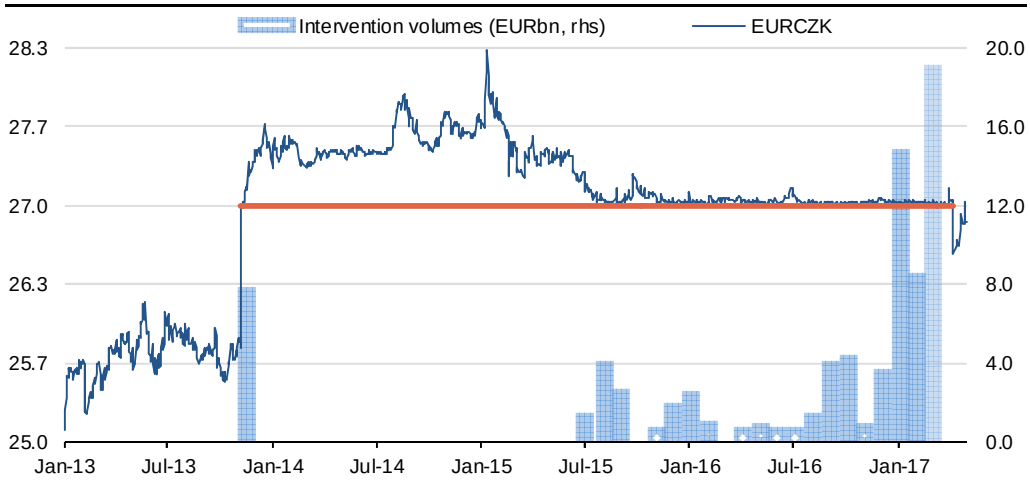
Czech FX Market

Koruna floating again, road to strengthening will be bumpy

FX intervention regime ended.

The CNB terminated the FX intervention regime on 6 April. The central bank bought roughly EUR75bn (CZK2trn) to defend the EUR/CZK27 level for the duration of the FX commitment. The level of foreign exchange reserves increased to EUR122.6bn at the end of 1Q17, almost 70% of GDP. At the end of last year, the level stood at below 47% of GDP. The first three months of this year showed signs of an extraordinary high inflow of speculative capital into the economy. We think that these large speculative positions will drive exchange rate developments for the rest of this year as well as in the following years.

EUR/CZK development and intervention volumes (EURbn)



Source: CNB, Datastream, Economic & Strategy Research, Komerční banka, Note: Intervention volumes for March 2017: KB estimate

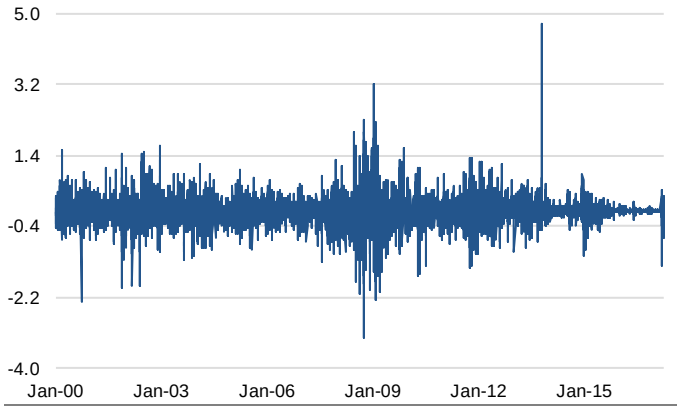
Central bank will still intervene should there be significant deviations that jeopardise the fulfilment of its inflation target.

After 41 months, EUR/CZK has returned to a managed floating regime, and the development of the exchange rate is now in the hands of market forces. However, the CNB reserves the right to intervene to correct the rate in the event of an excessive and long-lasting deviation that jeopardises the fulfilment of its inflation target. Such a deviation would materialise if the rate leaves the range of EUR/CZK25-28. We discuss this in more detail in the *CNB Focus* section of this report.

The exit was smooth.

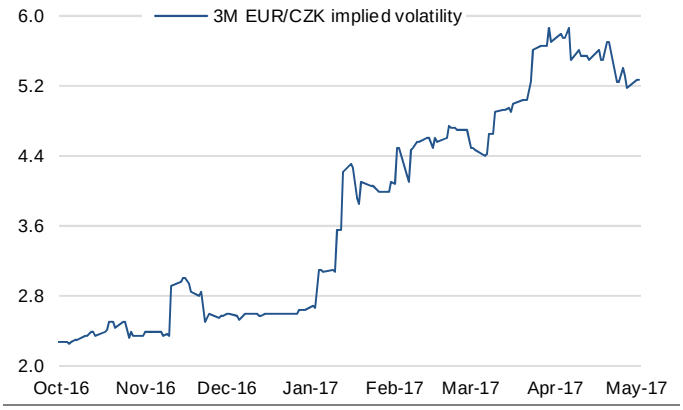
The return to a managed floating regime means increased exchange rate volatility, though this has so far lagged expectations. In the days after the exit, EUR/CZK reached 26.50 but did not break this support level. In the following two weeks, it corrected to 27. Looking at intraday developments, EUR/CZK is less volatile than before the introduction of the exchange rate regime. Implied volatility, i.e. the volatility expected by the market, had increased in the first three months of this year in expectation of an exit from the FX regime. Investors speculated that the currency would be free floating within three months and that volatility would increase significantly. Nevertheless, developments after the exit have lagged expectations, and implied volatility has even declined slightly.

Daily EUR/CZK changes



Source: Bloomberg, Economic & Strategy Research, Komerční banka

3M EUR/CZK implied volatility



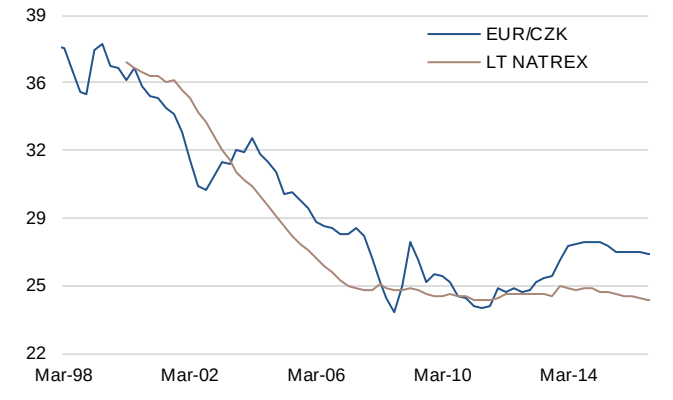
Source: Bloomberg, Economic & Strategy Research, Komerční banka

Currency undervalued from fundamental point of view

Fundamentals favour stronger Czech koruna

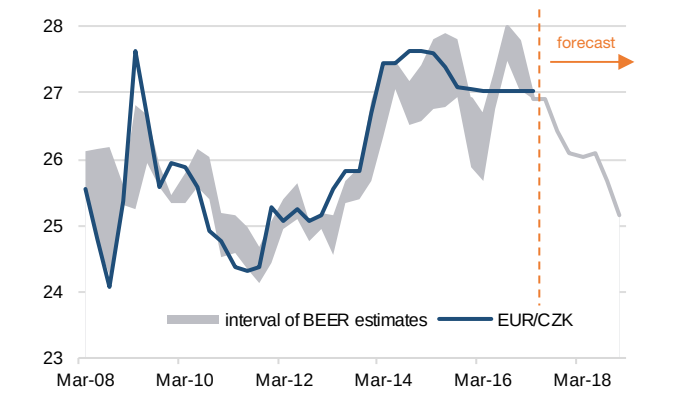
From the fundamental point of view, the Czech koruna should be stronger. From the longer-term perspective, according to the NATREX approach, we see the exchange rate at EUR/CZK24.60. This assumes the Czech economy at the equilibrium level and ignores the role of speculative investors. However, a quick return of EUR/CZK to the NATREX level is not desirable. The strengthening of the crown against the euro must be gradual in order not to generate a shock to the Czech export-oriented economy. From the mid-term point of view, according to the BEER models, the current fundamentally justifiable exchange rate should stand at EUR/CZK26.60. We see BEER EUR/CZK at 25.7 by the end of this year.

Long-term equilibrium EUR/CZK exchange rate, based on NATREX



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Medium-term EUR/CZK equilibrium exchange rate, based on BEER



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Overbought koruna will hamper quick return to fundamentally justified level

Difficult for speculative investors to realise profits.

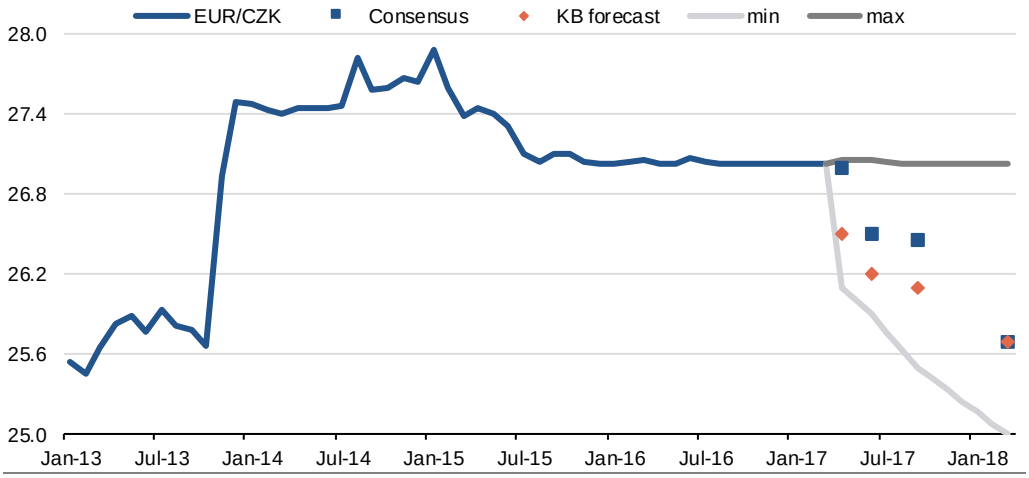
The big speculative position limits the space for quick appreciation of the Czech koruna. There was a massive inflow of speculative capital from the second half of last year, and this gathered momentum in early 2017. Together with the exit from the FX commitment, this has seen the missing counterparty effect become fully evident. How will euros be delivered to the market and allow speculative investors to take profits? We assume, the CNB will not put euros back into the market at current levels. It could happen should a noticeable weakening of the koruna threaten the fulfilment of the inflation target. We think the CNB would intervene in the market with EUR/CZK at over 28. A natural way would be via real flows whereby exporters

supply euros. However, the amount exports generate is significantly lower than the speculative position. In addition, according to our estimates, exporters have hedged euros for this year by roughly two-thirds. The last possibility is that old speculative investors are replaced by new ones. The main factor attracting new speculative investors could be a more attractive interest rate differential. We discuss the prospects for interest rates in the *CNB Focus* section and the *Czech Government Bonds and IRS Market* section.

Koruna should strengthen over forecast horizon.

In line with market expectations, we expect that the koruna will be stronger over a one-year horizon and that the exchange rate will move closer to its fundamental value. We expect an attack on the EUR/CZK26 level by the end of the year. The koruna might even strengthen below this level given the interest rate differential (more about interest rates in *CNB Focus* section). Nevertheless, we see EUR/CZK at 26.40 by the end of this year. The large speculative position will strengthen the year-end effect that was evident in the pre-intervention period. This effect is also related to the Resolution Fund and the closing of speculative positions. We expect EUR/CZK at around 25.50 by the end of 2018.

Expected EUR/CZK exchange rate – market consensus, April 2017



Source: Reuters, Economic & Strategy Research, Komerční banka

Risks skewed toward weaker levels for koruna.

The big speculative position represents a risk of higher volatility over our forecast horizon (end-2018). We consider this risk asymmetric toward a possible noticeable weakening, albeit temporarily, of the Czech koruna. In April, the uncertainty ahead of the French elections protected the koruna from strengthening. This shows that the speculative positions make the exchange rate sensitive to any shocks. A sell-off trigger could arise from external events, not only economic but geopolitical too. We discuss this in the *External Environment and Assumptions* section. Just because volatility was relatively low in April does not mean it cannot substantially increase in the coming months.

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EUR/CZK Technical Analysis

Another leg of down move may unfold towards the multiyear trend at 26.20/26.15.

After finding stiff resistance near the multiyear ascending channel (currently at 28.80/29.00), EUR/CZK has been undergoing a correction. Recently it breached below the pivotal support at 27.00/27.07 confirming possibility of a larger down move. Monthly MACD is now entering into negative territory suggesting possibility of a deeper correction towards lower bound of aforementioned channel at 26.20/26.15, also the graphical support consisting of 2011 / 2013 highs and the 50% retracement of the up move. This will remain an important support.

Shorter term, the pair is undergoing a tentative recovery and is retesting the previous cap levels at 27.00/27.07; however this should be corrective in nature. Recent highs of 27.28/27.32, also a weekly descending trend and the 38.2% retracement from 2015 highs should be a prominent hurdle.

EUR/CZK, monthly chart.

EUR/CZK, weekly chart.

Source: SG Cross Asset Research/Technical Analysis

Important Disclaimer: The recommendations in the part Technical analysis is based only on analytical methods of technical analysis and may be different from the fundamental opinion of KB (or SG) presented in other part s of this documents or of other documents of KB (or SG).

Czech Government Bonds and the IRS Market

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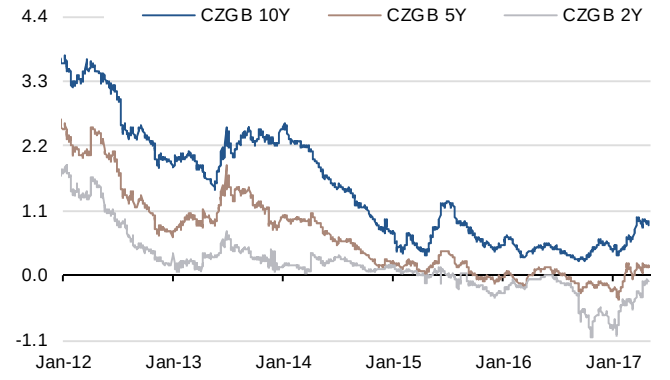
Following the exit, CZGB supply to drop until September

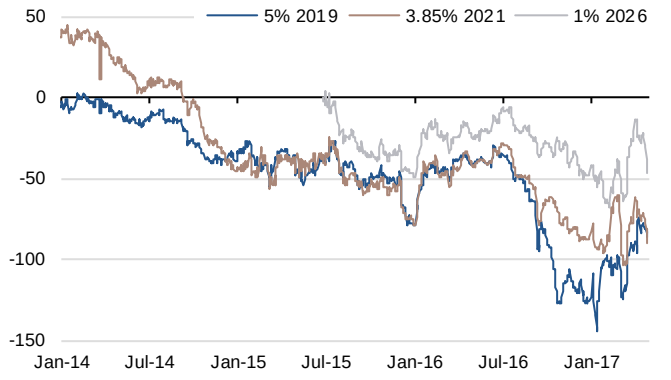
Despite the CNB's exit and the decline in demand, CZGBs have remained resilient versus any major selloff so far. Still, we expect yields should increase in 2017 due to the expected bearish developments in Bunds, elevated inflation, the CNB's hikes and crowded positioning. That said, lower supply in 2Q and 3Q17 should slow this rise in yields, while the year-end effect of the Resolution fund is set to richen CZGBs in late 2017.

CZGB yields, Bloomberg generic (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

ASW spreads (bp)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

The end of the CNB's FX floor has had two major effects in the CZGB market. (1) Yields increased, mainly on the short end, so the curve bear flattened. (2) Demand dropped for bonds along the curve, as the two post-exit auctions already showed. Still, short-end CZGB yields (up to 2Y maturity) have remained in negative territory and long-end CZGBs have proven relatively resistant to the selloff after the market-friendly result of the first round of the French presidential elections.

Supply side: Drop in sales in 2Q-3Q17 expected

We have made a minor update to expected 2017 financing although we have kept the gross borrowing needs outlook unchanged. On the borrowing side, we continue to predict the budget deficit will be lower this year compared with the plan. On the financing side, we have increased the expected sales of T-bills with a maturity in 2018 (so that they will cover 2017 borrowing needs). On the other hand, we have cut the expected effect of CZGB switches to zero (to-date, the Finance Ministry has been only performing switches that equal themselves in terms of the effects on financing) and slightly lowered the expected tap of the liquidity reserve.

Year-to-date, the Finance Ministry has covered 49% of expected gross borrowing needs, adjusted for the liquidity reserve tap.

Year-to-date, the Finance Ministry has covered 49% of expected gross borrowing needs, adjusted for the liquidity reserve tap, according to our latest calculations. The government has sold CZK118.6bn of CZGBs in primary-market auctions, or 54% of our full-year outlook.

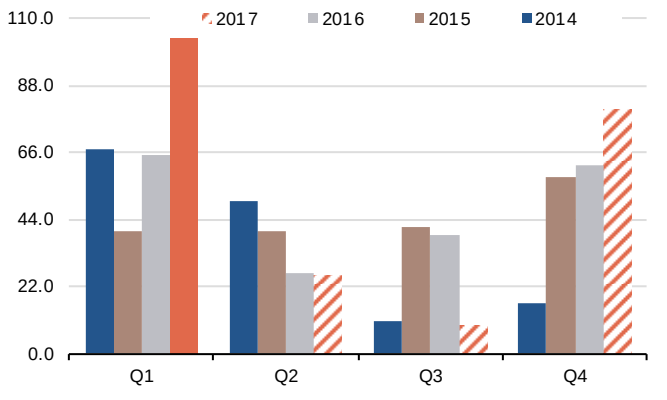
2017 gross borrowing needs and financing, CZKbn

	MinFin Dec	KB Jan
Borrowing needs		
Budget deficit	60.0	45.0
Buybacks of CZGBs		0.0
Redemption of CZGBs	207.9	207.9
Redemption of Eurobonds		0.0
Redemption of retail bonds	16.8	16.8
Redemption of T-bills	4.2	4.2
Redemption of other money market instruments	0.0	0.0
Redemption of EIB loans	1.7	1.7
Total	**290.6**	**275.6**
Financing		
Gross T-bill issuance		*(+15.0)* 30.0
Other money market instruments		0.0
Gross CZGB issuance (in auctions)	min 150.0	220.0
Tap sales		*(+0.6)* 10.6
Gross issuance of eurobonds		0.0
Gross issuance of retail bonds		0.0
Tapping of financial reserve		*(-5.6)* 15.0
Net effect of CZGB switches		*(-10.0)* 0.0
Total financing		**275.6**
Net CZGB issuance		*22.7*

Source: Economic & Strategy Research, Komerční banka, Finance Ministry (numbers in brackets mark the changes in the outlook)

We expect the ministry will tend to report that government debt would have dropped by end-3Q17, compared with end-2016 or previous years.

Quarterly CZGB issuance on the primary market, CZKbn (dashed bars mark our expectations)



Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Following this heavy frontloading of 1Q17 (government debt increased by CZK175bn versus end-2016), we assume that the ministry will slow its issuance activity in 2Q-3Q17 ahead of the parliamentary elections. The curbing of government debt has been an important narrative of Finance Minister Babis, whose party is leading the polls ahead of the elections (see the *Fiscal Outlook*). **We expect the ministry will tend to report that government debt would have dropped by end-3Q17, compared with end-2016 or previous years**. In order to do so, the ministry has been selling T-bills with maximum maturity in August and September (the same is planned for May's T-bill calendar). The volume of T-bills is therefore set to drop to zero by the end of 3Q17, in our view (if the ministry doesn't start to sell T-bills with longer maturities, which would be a surprise). **On the CZGB front, issuance is likely to slow considerably through September**, which is in line with the release of the May CZGB auction calendar, where only one (triple) offering is scheduled. CZGB repayments in 2Q17 and 3Q17 of almost CZK140bn are then set to slash the volume of debt below the 2016 level as of 3Q17.

However, we expect the ministry will need to rapidly restart debt issuance in 4Q17 to cover the budget deficit and repayments of CZGBs and retail bonds. **We estimate that CZGB sales**

in primary-market auctions would thus be set to reach CZK80bn in 4Q17, the highest 4Q figure ever. As stated above, we also assume the ministry will sell CZK30bn of T-bills in 4Q17 with maturity in 2018. Note that the ministry can decide to alter T-bill/CZGB sales in relative terms and also absolute terms (via higher liquidity reserve tap).

Bond yields: Moderate increase for the remainder of the year

Government bond yields are set to increase for the rest of 2017.

Government bond yields are set to increase for the rest of 2017, in our view, due to lower demand after the end of the FX floor (due to the gradual normalisation of forward points/cross currency basis swaps), elevated inflation, and higher EUR rates/Bund yields. That said, the pickup on the long end should be mitigated by lower supply in the coming months. On the short end, we expect a slightly faster increase over the remainder of 2017, as in future more CNB rate hikes will start to be priced in, and due to the heavy foreign positioning on the front end. The curve should therefore flatten further.

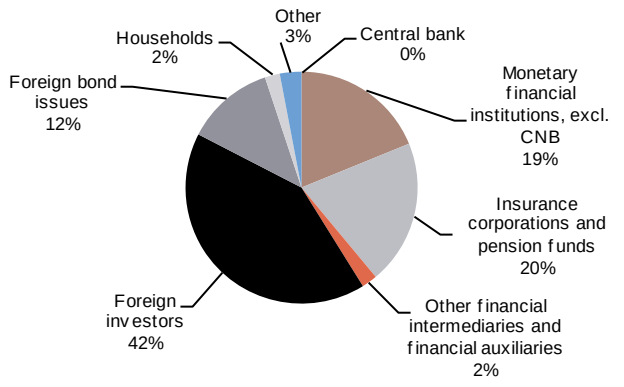
CZGB yield forecast

	2Q17f	3Q17f	4Q17f	1Q18f	2Q18f
2y CZGB yield (%)	0.15	0.30	0.35	0.70	0.90
10y CZGB yield (%)	0.90	1.10	1.10	1.45	1.60
10y CZGB ASW (bp)	-30	-30	-45	-30	-30

Source: Economic & Strategy Research, Komerční banka

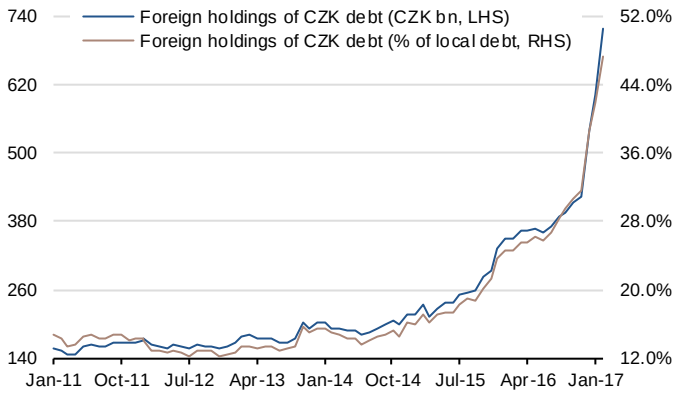
Given the faster increase in IRS, long-end CZGBs should richen in ASW terms going forward. We expect the regular year-end payments of the banking sector into the Resolution fund will again have tangible effects in the CZGB market. **The push by banks to lower their balance sheets is likely to result in higher demand for bonds and further richening**, which should mitigate the bearish trends related to high inflation and the ECB's QE tapering.

Holdings of Czech Republic's debt securities, end-Mar 2017



Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Massive increase in non-resident holdings in 1Q17



Source: Finance Ministry, Economic & Strategy Research, Komerční banka

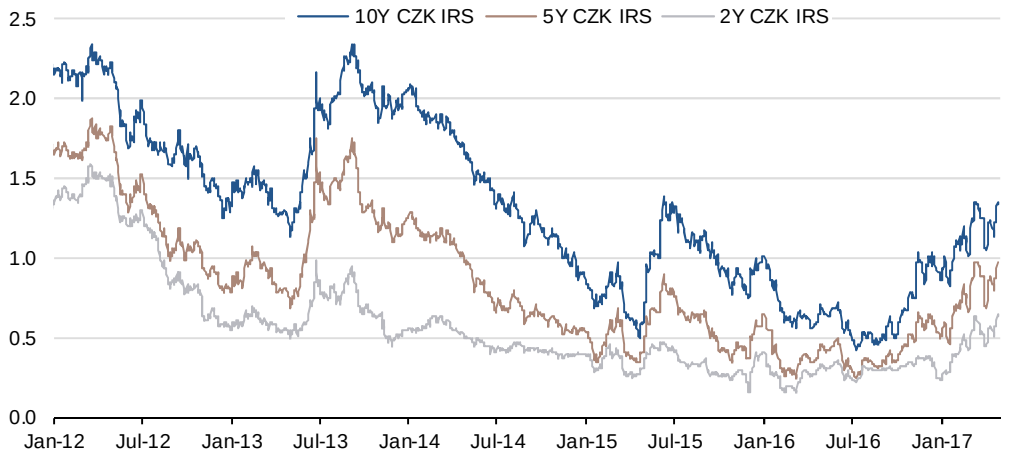
CZGB holders: Non-resident holdings skyrocketed in 1Q17

As of end-March, non-residents held as much as 44% of local debt, a historical high.

The cheap CZK financing and speculation on koruna strengthening resulted in a massive increase in foreign ownership of CZK-denominated debt (bonds and T-bills). **As of end-March, non-residents held as much as 44% of local debt, a historical high**. We assume most of the foreign holdings are concentrated on the front end (as local investors had few incentives to buy the sub-zero yielding papers), but the magnitude of the increase in non-resident ownership (and a decline in domestic banks' holdings) suggests there was significant foreign demand for longer papers on the secondary market too (likely due to the GBI-EM inclusion). We continue to expect that the front-end non-resident position is likely to result in a

faster increase in yields, especially around the turn of the year when CZK130bn of zero-coupon bonds are due. As stated above, however, the increase in yields will likely be mitigated by effects of the Resolution fund payments.

Recent developments of CZK IRS (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

CZK interest rate swaps: Short-end to increase faster due to CNB's hikes

We have increased the estimated path of the short end of the curve.

While we have made few changes to the expected development of long-end IRS, **we have increased the estimated path of the short end**. As we moved the first CNB's hike into 4Q17, the short end of the CZK IRS curve should soon reflect the coming rise in the monetary policy and PRIBOR rates. The long end is to increase during the remainder of the year mainly due to higher EUR rates, elevated inflation, and continuing strong economic performance. CZK IRS should rise further next year and peak in 2H18.

CZK IRS outlook (%)

	2Q17f	3Q17f	4Q17f	1Q18f	2Q18f
2Y	0.55	0.65	0.85	1.10	1.20
10Y	1.20	1.40	1.55	1.75	1.90

Source: Economic & Strategy Research, Komerční banka

Risks: Balanced on both sides

If global economic growth disappoints or geopolitical clashes intensify, the risk-off mood could hamper any potential increase in rates and yields, mainly on the long-end of the CZGB curve (short-end may be susceptible to sell-offs due to the heavy foreign positioning). On the other hand, risks to the upside stem mainly from: (1) faster-than-expected hikes by the CNB, (2) intensification of the reflation story in the main global markets, and (3) the strategy of the Finance Ministry – concentrated redemptions of zero-coupon bonds around the turn of the year, and the expected election-related cycle in debt issuance.

Banking Sector

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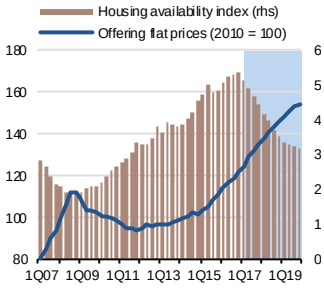
Housing Availability Index to decline



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Sharp drop in corporate credit creation expected

We continue to expect that the growth of overall bank loans will slightly decelerate this year. **This development should be driven mainly by a sharp slowdown in corporate credit creation, in our view**. Investment will start to pick up only slowly, corporates still have large amounts of cash, and the elevated statistical base of the pre-CNB exit period (when corporates heavily tapped non-CZK loans as a natural hedging) should all mitigate the pace of lending in the corporate segment. The growth of mortgage lending is also set to moderately slow. Housing prices are skyrocketing and the increase in real disposable income will be lower this year due to elevated inflation. Market saturation has been growing due to massive demand, which has been boosted also by the upcoming stricter regulation of LTVs etc.

Deposits should increase faster than in 2016 due to increased inflation, the continuing strong growth of nominal income, the elevated profitability of corporates and a lack of investment opportunities.

Bank loans and deposits (yoy, %)

	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	2016	2017	2018	2019	2020	2021
Bank loans														
Total	7.2	5.9	5.2	6.1	4.4	5.3	6.0	6.4	**6.5**	**6.1**	**5.5**	**5.7**	**3.9**	**3.6**
Households - real estate loans	9.1	8.1	6.4	5.1	3.9	4.3	5.7	6.7	**8.1**	**7.2**	**5.2**	**7.0**	**5.0**	**4.2**
Households - consumer loans	5.1	5.5	4.9	4.6	4.4	4.8	6.2	7.4	**4.7**	**5.0**	**5.7**	**7.4**	**5.0**	**4.4**
Corporate loans	4.0	2.1	1.1	3.2	3.8	5.8	6.0	5.9	**6.8**	**2.6**	**5.4**	**4.3**	**3.1**	**3.4**
Deposits														
Total	8.9	8.5	7.7	5.8	1.8	3.1	3.2	4.5	**6.4**	**7.7**	**3.1**	**2.9**	**2.0**	**2.6**
Households	9.2	8.8	8.6	8.0	7.0	6.5	6.1	5.7	**7.4**	**8.7**	**6.3**	**4.5**	**2.3**	**2.5**
Non-financial corporations	7.2	7.9	5.2	12.8	3.2	3.7	3.5	4.2	**4.7**	**8.3**	**3.6**	**3.5**	**1.1**	**2.9**
Others	10.0	8.3	8.2	-7.7	-9.4	-5.2	-3.6	1.2	**6.3**	**4.7**	**-4.3**	**-1.7**	**2.3**	**2.7**
Ratios														
Loan-to-GDP ratio	64.0	63.8	63.9	63.5	63.6	63.7	64.3	64.2	**62.3**	**63.8**	**64.0**	**64.6**	**65.3**	**66.0**
Deposit-to-GDP ratio	86.3	83.6	83.2	80.9	83.6	81.8	81.4	80.4	**80.3**	**83.5**	**81.8**	**80.4**	**79.9**	**80.0**
Loan-to-deposit ratio	74.2	76.2	76.9	78.5	76.1	77.9	79.0	79.9	**77.6**	**76.4**	**78.2**	**80.4**	**81.8**	**82.6**
Interest rates														
Real estate loans	2.2	2.3	2.4	2.4	2.6	2.7	2.9	3.0	**2.2**	**2.3**	**2.8**	**3.2**	**3.5**	**4.1**
Consumer loans	9.4	9.5	9.3	9.2	9.2	9.5	9.6	9.8	**10.6**	**9.4**	**9.6**	**10.1**	**10.1**	**11.2**
Corporate loans	2.0	2.1	2.1	2.2	2.5	2.7	2.9	3.1	**2.0**	**2.1**	**2.8**	**2.9**	**2.9**	**4.0**
Share of NPL														
Real estate loans	1.9	1.9	1.9	1.9	1.9	1.9	1.9	2.0	**2.2**	**1.9**	**1.9**	**2.0**	**2.2**	**2.5**
Consumer loans	8.8	8.4	8.3	8.3	8.0	7.9	7.9	8.1	**9.4**	**8.5**	**8.0**	**8.7**	**9.5**	**10.1**
Corporate loans	5.2	5.2	5.1	5.1	5.1	5.1	5.1	5.0	**5.1**	**5.1**	**5.1**	**5.1**	**5.4**	**5.9**

Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2014	2015	2016	2017	2018	2019	2020	2021
GDP	real, %	2.7	4.6	2.3	2.7	2.7	2.3	1.5	1.9
Inflation	average, %	0.4	0.3	0.7	2.3	2.3	1.7	0.7	1.2
Current account	% of GDP	0.2	0.2	1.1	1.0	0.7	0.9	1.1	1.1
3M PRIBOR	average, %	0.4	0.3	0.3	0.3	1.0	1.0	1.0	2.1
EUR/CZK	average	27.5	27.3	27.0	26.4	25.8	24.8	23.8	23.0
USD/CZK	average	20.8	24.6	24.4	24.4	23.2	21.1	19.7	18.9

Source: CZSO, CNB, Macrobond, Economic & Strategy Research, Komerční banka, SG Economic Research
Note: KB forecasts are in blue

FX & interest-rate outlook

		1-May-2017	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
EUR/CZK	end of period	26.86	26.20	26.10	26.40	26.00	25.90
USD/EUR	end of period	1.090	1.07	1.09	1.09	1.10	1.12
CZK/USD	end of period	24.64	24.49	23.94	24.22	23.60	23.20
3M PRIBOR	end of period	0.29	0.29	0.29	0.49	0.75	0.80
10Y IRS	end of period	1.35	1.20	1.40	1.55	1.75	1.90

Source: CZSO, CNB, Macrobond, Economic & Strategy Research, Komerční banka, SG Economic Research
Note: KB forecasts are in blue

Monthly macroeconomic data

		VII-16	VIII-16	XI-16	X-16	XI-16	XII-16	I-17	II-17	III-17
Inflation (CPI)	%, mom	0.3	-0.2	-0.2	0.3	0.3	0.3	0.8	0.4	0.0
Inflation (CPI)	%, yoy	0.5	0.6	0.5	0.8	1.5	2.0	2.2	2.5	2.6
Producer prices (PPI)	%, mom	0.0	-0.1	0.2	0.5	0.1	0.5	0.7	0.4	-0.1
Producer prices (PPI)	%, yoy	-4.0	-3.3	-2.4	-1.7	-1.3	-0.3	2.1	3.1	3.0
Unemployment rate	% (MLSA)	5.4	5.3	5.2	5.0	4.9	5.2	5.3	5.1	4.8
Industrial sales	%, yoy, c.p.	-19.1	14.5	1.3	-2.3	7.8	4.6	12.5	4.8	n.a.
Industrial production	%, yoy, c.p.	-13.9	13.3	2.7	-1.7	7.1	2.7	10.3	2.7	n.a.
Construction output	%, yoy, c.p.	-12.5	-2.4	-5.2	-6.4	-1.4	2.6	-1.4	-7.0	n.a.
Retail sales	%, yoy, c.p.	-0.4	11.4	4.7	0.5	8.6	3.7	7.8	1.1	n.a.
External trade	CZK bn (national met.)	0.1	7.2	19.6	15.1	8.6	-7.8	20.7	17.9	n.a.
Current account	CZK bn	-22.2	-4.5	3.9	3.9	-13.9	-12.8	29.4	28.2	n.a.
Financial account	CZK bn	2.8	8.4	-13.1	23.1	-20.3	8.7	5.9	26.4	n.a.
M2 growth	%, yoy	7.1	7.6	6.7	6.3	6.7	5.9	8.1	n.a.	n.a.
State budget	CZK bn (YTD cum.)	75.6	81.2	82.3	98.3	55.5	61.8	9.1	3.7	4.7
PRIBOR 3M	%, average	0.29	0.29	0.29	0.29	0.29	0.29	0.28	0.28	0.28
EUR/CZK	average	27.04	27.02	27.02	27.02	27.03	27.03	27.02	27.02	27.03
USD/CZK	average	24.44	24.12	24.10	24.51	25.07	25.65	25.42	25.40	25.29

Source: CZSO, CNB, MF, MLSA, Macrobond, Economic & Strategy Research, Komerční banka

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